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FM AMEMBASSY YEREVAN
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INFO RUCPDOC/USDOC WASHDC
RUEATRS/DEPT OF TREASURY WASHDC 0509
RUCNCIS/CIS COLLECTIVE
RUEHAK/AMEMBASSY ANKARA 1305
RUEHIT/AMCONSUL ISTANBUL 0576
RUEHLMC/MILLENNIUM CHALLENGE CORP

UNCLAS SECTION 01 OF 04 YEREVAN 001093

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E.O. 12958: N/A

TAGS: ECON EFIN EAID

SUBJECT: MACROECONOMIC OVERVIEW FOR THE FIRST HALF OF 2007

REF: A) 06 YEREVAN 269

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SUMMARY

¶1. (SBU) Double-digit expansion of Armenia's economy continued in the first half of 2007, with GDP growth equal to 11.2 percent year-on-year. As in the previous year, the growth was driven mostly by construction and services. The inflation rate in June was 4.8 percent year-on-year, due to rising food and fuel prices, as well as growth in government spending and large inflows of cash remittances.

The budget posted a surplus of USD 9.6 million, with revenues and expenditures (foreign-financed programs included) increasing by 26.7 percent and 18.2 percent respectively. The trade deficit expanded by 64 percent, with import and export revenues increasing by 44 percent and 20.5 percent respectively. The Armenian Dram appreciated by nearly 18 percent against the dollar between June 2006 and June 2007. Foreign direct investment (FDI) almost doubled year-on-year in the first quarter of 2007, most of that investment being made in the telecommunications sector.

GROWTH REMAINS STRONG

¶2. (SBU) During the first six months of 2007, Armenia's GDP grew 11.2 percent (compared to the same period of 2006) to approximately USD 2.7 billion (AMD 944,845.7 million), according to the National Statistical Service. GDP per capita in January-June 2007 was equal to USD 822. Construction, trade and services were the main driving forces of the growth. The construction sector expanded by 20.1 percent year-on-year, and accounted for 17 percent of overall GDP, contributing 3.1 percentage points to the overall GDP growth rate. (NOTE: The rate of growth in the construction sector slowed down considerably, compared to 37.7 percent growth in the first six months of 2006. END NOTE). The rapid construction growth was led by a surge in roadbuilding, as well as construction of high-end, mid-rise residential and office towers in the center of Yerevan. The construction industry will also receive additional boost from new projects in the energy and transport sectors. The services sector, which accounted for 4.7 percentage point contribution to the GDP growth, rose by 13.4 percent. Transport and communications, trade and catering collectively increased by 13.7 percent and financial services grew by 24.6 percent.

¶3. Industrial output (energy sector included) increased by 2.3 percent year-on-year to around USD 920 million, against a 1.4 percent decline in same period of 2006. The industry share in overall GDP was equal to 21.8 percent, compared to 25 percent in the first half of 2006. The poor performance of the industry is mainly

explained by a continued downturn in the diamond sector since 2004. In the first half of 2007, the diamond industry declined by 48 percent, to USD 75 million (approximately AMD 25 billion) mainly attributed to global diamond industry crisis, as well as appreciation of the Armenian Dram. (Septel will report on the Armenian diamond sector in detail) Overall, manufacturing output contracted by 0.1 percent, despite considerable growth registered in the metallurgy (up by 7.3 percent) and food production (up by 12.2 percent). Industrial output without diamonds grew by 8.2 percent totaling USD 911.5 million.

¶4. The agricultural sector contracted by 1.8 percent year-on-year and accounted for 13.3 percent of GDP at approximately USD 356 million. The decline was mainly due to unfavorable weather conditions, which particularly hurt the fruit and vegetable sub-sectors.

NEW GOVERNMENT HAS AN ABITIOUS PROGRAM

¶5. In June, the Armenian Parliament approved a new economic program that aims for at least eight percent annual economic growth and reduction of the poverty rate from 30 percent currently to 12 percent by 2012. One goal of the program will be to increase the ratio of tax collections to GDP - at 14.4 percent in 2006 the lowest among CIS countries - by increments of at least .3 percentage points annually. The program also aims for investment to grow by at least 10 percent annually, and envisages further strengthening of regional self-governance bodies and improvement of their financing.

PRICES INCREASE

¶6. In June 2007, inflation was equal to 4.8 percent year-on-year (up YEREVAN 00001093 002.2 OF 004

by 2.1 percentage points in the June 2006 figure). Prices of foodstuffs (including alcohol and cigarettes) were up by 6.2 percent compared to January-June 2006, prices of services grew by 5.3 percent, and the prices of non-food products decreased by 0.9 percent. The increase in food prices came largely from increased fruit and vegetable prices (18.2 percent and 30.7 percent increases compared to June 2006, respectively). Between May and June 2007, bread and bakery product prices increased 10.3 percent, wheat 13.3 percent and flour 7.5 percent due to increased world wheat prices, and particularly in the Russian market. Average inflation for January-June 2007 was equal to 4.5 percent compared to the same period of the last year. If these trends continue, the year-end inflation may exceed the Government's four percent target for 2007.

¶7. Prices in the first half of 2007 rose 5.1 percent for construction materials and 5.8 percent for agricultural products. Freight shipping prices rose 24.3 percent, due primarily to a 61-percent increase in pipeline transportation costs in the beginning of the year.

DRAM CONTINUES TO APPRECIATE

¶8. The value of the Dram increased 5.4 percent against the dollar during the first half of 2007, and in June 2007 was 18 percent higher against the dollar compared to June 2006. While the process slowed considerably in the first quarter of 2007, the appreciation trend picked up in the second quarter. The average exchange rate in June was at AMD 344.8/USD, 41 percent lower than in June 2003. The main causes of Dram appreciation remain the global weakening of the U.S. dollar, a large inflow of foreign currency to Armenia from remittances (especially dollar remittances from Armenian workers in Russia), as well as increases in domestic productivity and incomes.

HOUSEHOLD INCOMES AND REVENUES RISE

¶19. In the first half of 2007, household incomes rose 26 percent compared to the same period of 2006, and totaled AMD 853 billion (around USD 2.4 billion), a growth supported by higher monthly wages and remittances. Average monthly wages for the period of January-May 2007 were AMD 71,000 (approximately USD 200), a nominal increase of 17.4 percent compared to the same period in 2006. The highest wages were paid in the financial services sector (USD 600), followed by the mining (USD 420) and energy sectors (USD 300). Average monthly wages in the public sector were equal to USD 200, up by 20 percent year-on-year. Taking into consideration the relatively low inflation rate, real wages rose by around 10 percent year-on-year in May 2007.

¶10. According to the Central Bank of Armenia (CBA), individual net cash inflows through commercial banks were equal to USD 378 million in January-June 2007, up by 36 percent year-on-year. According CBA estimates, the amount of remittances in 2007 will reach approximately USD 1.3 billion, as similar amounts of remittances enter the country through non-bank transfers, and the majority of remittances are transferred in the second half of the year.

UNEMPLOYMENT REMAINS UNCHANGED

¶11. According to the National Statistical Service, unemployment was 7.2 percent in the first half of 2007, compared to 7.6 percent the same period of 2006. Seventy-two percent of officially registered unemployed were women.

HIGHER REVENUES RESULT IN SMALL BUDGET SURPLUS

¶12. According to preliminary data from the Ministry of Finance and Economy, budget revenues in the first half of 2007 were approximately USD 686 million, up by 26.7 percent compared to the same period in 2006 (calculated in terms of local currency). Taxes, which accounted for 82.2 percent of total budget revenues, rose by 27 percent year-on-year to approximately USD 564 million, equivalent to 21.3 percent of GDP. (NOTE: The Tax/GDP ratio is typically significantly higher in the first half of the year, as many large tax collections occur in the first part of the year, while GDP tends to be higher in the second part of the year. END NOTE) The increase in tax revenues was due primarily to growth in VAT collections (an increase of 39.3 percent compared to the same period of 2006), which

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provided for 48 percent of total tax revenues. Corporate profit tax collections increased by 14.4 percent and comprised 18.6 percent of total tax revenues. Budget expenditures increased by 17.5 percent to approximately USD 640 million (USD 676.8 million, foreign financed programs included). A small budget surplus of USD 9.2 million (foreign-financed programs included) was posted in the first half of 2007, compared to deficit of approximately USD 25 million during the same period of 2006. In July 2007 the Armenian National Assembly adopted a decision to increase budget revenue and expenditure targets for 2007 by AMD 25 billion (around USD 70 million), which will be raised from land privatization and additional tax revenues.

¶13. Expenditures on education and science increased considerably, to USD 109 million, up by 16.9 percent compared to the same period of 2006, comprising 4.1 percent of GDP. Despite 12.7 percent growth in health expenditures to USD 48.3 million, its share of GDP remained just 1.8 percent.

¶14. In May 2007, the Government of Armenia adopted a three-year Strategic Development Program for the tax system of Armenia, aimed at increasing tax collections through a number of structural, legislative and technological changes within the State Tax Service. As a part of the reform, the amended law on Simplified Tax, which was adopted by the parliament in July 2007, will considerably

decrease the number of taxpayers that were allowed to pay the "simplified tax" instead of other, higher taxes. (NOTE: The "simplified tax" is a tax on gross receipts (currently 3.5 percent of sales turnover) and was intended for smaller companies. The GOAM moved to curb its use when larger enterprises found it advantageous to pay it in place of the VAT or profit tax. END NOTE).

FOREIGN TRADE DEFICIT EXPANDS

¶15. Armenia's trade deficit increased by 64 percent year-on-year in the first half of 2007 to USD 838 million, owing to a surge in imports. Total trade turnover grew by 36.5 percent, reaching USD 1,892 million, with exports equal to USD 527 million (up by 20.5 percent) and imports equal to USD 1,365 million (up by 43.9 percent). Rising costs of mineral products were one of the driving factors behind import growth, while exports suffered mainly from the poor performance of the diamond processing industry. Excluding diamonds, exports grew by 37.1 percent and imports rose by 53.9 percent. Continuing growth in the metallurgy sector resulted in base metals becoming the largest export commodity group. In the first six months of 2007, exports of base metals, which comprise 34.3 percent of total exports, were equal to USD 181 million, recording 36.4 percent growth compared to the same period of the last year. Export volumes of precious stones and metals slumped by 23.9 percent.

¶16. The share of the Commonwealth of Independent States (CIS) in overall trade increased considerably, accounting for approximately 32 percent of the total. Russia remained Armenia's largest trading partner (14.6 percent of total trade turnover), with overall trade between the countries increasing by 54.5 percent year-on-year. The second-largest trading partner was Germany (9.2 percent), followed by Kazakhstan (6.8 percent), and Ukraine (6.6 percent). The U.S. share remained at 5.4 percent of overall trade turnover.

FOREIGN DIRECT INVESTMENT DOUBLES

¶17. Foreign investment reached USD 136.63 million in January-March 2007, up by 45 percent compared to the same period in 2006. Foreign direct investment almost doubled year-on-year in the first quarter of 2007 to USD 88.9 million. During this period the leading investor was Lebanon (USD 34.7 million), accounting for about 40 percent of total FDI in this period through Lebanese firm K-Telecom, which operates Vivacell, a two-year-old firm that is now the largest mobile phone operator in Armenia. The second-largest investor was Russia (USD 23.5 million), which accounted for 26 percent of total FDI, 15.5 times more compared to the same period of 2006. The major part of Russian investment was in the telecom sector, through Armentel Telecommunications Company (now owned by the Russian company Vimpelcom). Thus, the telecommunications sector was the largest recipient of FDI in the January-March 2007 period, attracting 63.2 percent of total FDI. Shares of the next-largest FDI recipients - Civil Aviation and Food Processing - were 6.6 percent and 6.5 percent, respectively.

COMMENT

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¶18. Despite the fact that construction remains the main driving force for growth, the growth base is gradually expanding, with trade, communication and transport making considerable contributions to growth. This is a positive trend, as the construction sector almost certainly cannot sustain its torrid pace indefinitely. Some worry, in fact, that Yerevan may be headed for a real estate glut, given the explosion of downtown construction projects all nearing completion this year or next. However, the Millennium Challenge program is expected to inject tens of millions of dollars into roadbuilding over the next four years, which will tend to prop up the construction sector. The appreciation of the Armenian Dram

continues to remain a major concern for Armenian exporters, as it harms their competitiveness. The European Bank for Reconstruction and Development has warned that if the productivity of local manufacturers does not increase, the continuing Dram appreciation will eventually restrict economic growth.

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